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Fast Growing Advisory Program Presents Major Compliance Risks

By Danielle Verbrigghe October 5, 2018

Rep-as-advisor programs have made a surprising resurgence in popularity, but present major compliance risks for managed account sponsors and advisors, according to a report from **Cerulli Associates.**

These programs, where advisors have to seek client permission before making a portfolio change, shot up in assets as firms moved brokerage IRA clients over to fee-based advisory accounts to prepare for the now defunct Department of Labor (DOL) fiduciary rule.

Rep-as-advisor assets climbed 14% in 2015, and another 26% to $1.06 trillion in 2017, according to Cerulli data.

But that shift has only heightened the compliance risks firms face if they don't keep a tight leash on their advisors.

The biggest problem is likely to be reverse churning, says Tom O'Shea, director of managed accounts research at Cerulli. This can happen when an advisor simply parks investments within a rep-as-advisor account and collects a fee without making many trades or taking steps to continuously evaluate whether the portfolio is still appropriate for the client's needs.

This tends to occur when advisors who have moved from commission-based business to a fee-based program and operate the same way they did when working on commission, O'Shea explains.

"They can't just put products in the clients' accounts and collect a fee without reaching out to the clients, making sure the portfolio is appropriate and making changes where necessary," O'Shea says.

Another potential risk is inappropriately moving commission-based products, such as recently purchased front-loaded mutual funds, from a brokerage account into rep-as-advisor. The timing of such transactions could be a red flag for regulators.

Regulators, including the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC), have previously indicated that they plan to look at this very issue.

“If you put somebody into a lot of commission-based products and then flip them into a fee-based account, that would be a real issue,” O’Shea says.

These issues are of particular importance because rep-as advisor has been used as an introductory fee-based program for some advisors transitioning away from commission-based business, explains **Jody Cullinan**, director of product management and strategy at **Fiserv Investment Services**.

Rep-as-advisor is often used as “a baby step” to moving clients into full discretionary rep-as-portfolio-manager accounts, Cullinan says. “You get used to an AUM-based relationship and the client still has some control because there is some skepticism in the market as well on [whether] ‘the advisor is doing the right thing for me.’”

But another major risk may be reps who don’t have permission to take discretion in an account, making trades without client permission or an appropriate agreement in place.

“I’ve spoken to some executives who are concerned their reps are using these rep-as-advisor accounts and exercising discretion,” O’Shea says. “The words ‘informal discretion’ often get used to describe these relationships… where the advisors aren’t really going out to get permission.”

This obviously makes advisors vulnerable to regulators, and client arbitration, but can also pose risks for the firm, if they are failing to make sure their reps are adhering to the terms of client agreements regarding the use of discretion.

Some home offices are putting in place systems to reduce these risks, Cullinan says.

In order to prevent advisors from trading without permission, firms are using systems that won’t let an advisor execute a trade before filling out an affirmation form, indicating that they got permission from the client. But even this has limitations.

“You can’t do much about an advisor lying and saying they got the permission,” Cullinan says.

Additional steps to prevent this include sending push notifications to clients when an advisor has entered a trade in a client discretionary account. One potential step that firms aren’t necessarily doing today, but might consider in the future, is using a feedback tool that requires the client to click a confirm or acknowledge button before allowing the advisor to do the trade, she adds.

To prevent reverse churning, home offices are using compliance dashboards to create alerts on when advisors traded last, and the number of trades in a particular account per year.

Firms are also putting systems in place to require that advisors use planning and proposal tools.